September 24, 2003

Dear Patty:

Thank you for your interest regarding the proposed changes to the Federal oil valuation rule. As a follow-up to your September 8, 2003, meeting with the Associate Director, Minerals Revenue Management (MRM), you asked the following question and I would like to provide a response.

1. Why does the "Summary of Costs and Royalty Impacts" chart in the preamble to the proposed Federal Oil Rule have ranges when the revenue impacts regarding the 2000 Federal Oil Rule did not?

We have enclosed information on the royalty impact analysis to the proposed Federal Oil Rule. Please note that the royalty impact analysis is broken out by region not by state. State break outs are not available.

If you need additional information, please contact Lyn Herdt, Office of Congressional Affairs at 202-208-3821.

ROYALTY IMPACT ANALYSIS
OF AUGUST 20, 2003 PROPOSED FEDERAL OIL VALUATION RULE

In the August 20, 2003, proposed Federal oil valuation rule, MMS provided a summary of the estimated costs and royalty impacts of the proposed rule to all potentially affected groups: industry, State and local governments, and the Federal Government.

We estimated a royalty increase based on using NYMEX pricing for oil that is not sold at arm's-length and a royalty decrease for proposed additional allowable costs.

We further broke out the estimated royalty impact into three regions of the country because the June 2000 rule established different valuation methods for each region. For two of the three regions, the royalty impact estimates are shown in ranges rather than absolutes. Following is a summary explaining why we have included ranges in our royalty impact analysis.

<u>Estimated Royalty Increase Based on Using NYMEX Pricing:</u>

<u>"Rest of the Country"</u>:

For the "rest of the country" the primary reason for the range is variance in the amount of oil that will be taken in kind. Our estimates ranged from a low of 50,000 barrels per day (small refiner program only) to a high of 180,000 barrels per day (small refiner plus Strategic Petroleum Reserve). If 50,000 barrels were taken in kind, the "in value" barrels affected by the proposed rule would represent 77% of total offshore production. If 180,000 barrels were taken in kind, the "in value" barrels affected by the proposed rule would represent only 19% of offshore production.

<u>California and Alaska</u>:

For California and Alaska, because the proposed rule uses new oil types and locations as its basis, to compare the royalty impact of using NYMEX instead of ANS, we had to make adjustments for quality and location to make a meaningful ("apples to apples") comparison. The ranges in our estimates are because of the variation in the quality and location adjustments that exist in the California market.

More specifically, there are significant differences in the quality (gravity and sulfur) of crude oil produced in California. For example, Kern River is 13.4 degrees API and ANS is 29.5 degrees API. In adjusting the prices at these locations to a common gravity, we used gravity adjustment scales that can vary from 15 to 25 cents per degree of API gravity. In making adjustments for location, we used tariffs that can range from between 75 cents and $1.25 per barrel.

Rocky Mountain Region:

Neither of the situations that cause the estimates to include ranges for the "rest of the country" and for California/Alaska exist for the Rocky Mountain Region. While we do have an active royalty-in-kind program in Wyoming, the amount taken in kind has stayed relatively constant at about 4,000 barrels per day – an amount we did take into account in our estimates.

Royalty Decrease for Additional Allowable Costs:

For all three regions of the country, the reason for the ranges in our estimates of the royalty decrease for the proposed additional allowable costs is the fact that these costs can vary depending on the pipeline. For example, we estimate that the costs associated with line fill and with obtaining a letter of credit can both vary from between 2 and 5 cents per barrel.

For the "rest of country" the primary reason for the range is variance in the amount of oil that will be taken in kind as described above.